Regulators vs. Adam Smith

By Herbert Grubel

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The scandals involving major U.S. companies such as Enron, Global Crossing and WorldCom have been used to support recommendations for stricter regulations of American corporations and their accounting practices. As a result, the Sarbanes-Oxley Act, by far the most significant change to American corporate governance since the Securities Act of 1933 and the Securities and Exchange Act of 1934, was signed into law. A similar push for more regulation is on in Canada. As difficult as it may be in the current political climate, the Canadian government and regulators should resist these demands. There, as in the U.S., the remedy for business scandals is to restore the market for corporate control.

Shareholder Victims

The demands for more regulation are due to a number of recent developments. The compensation of executives relative to that of workers has risen dramatically. Much of that compensation is due to bonus payments and stock options designed to reward performance. Yet these incentive rewards often were paid when companies were mismanaged and sometimes went bankrupt, as with Enron. The accounting practices of some important corporations were found to have been deceptive, if not outright fraudulent, and often designed to fill the pockets of insiders. Shareholders were the victims of this behavior.

There have been two distinct kinds of responses to these alleged market failures in the U.S. One stems from politicians, government regulators and most of the usual suspects in the chattering class of academics and commentators who are skeptical of the capitalist system. These people saw the corporate wrongdoings as yet another confirmation that free markets are dominated by personal greed and cannot be trusted to serve consumers, stockholders, workers and the general public interest. Government regulation, they argue, is needed to make corporations behave in the best interest of all stakeholders.

The second group of people is in a distinct minority. They believe that Adam Smith was right—individuals mostly pursue their self-interest and are greedy. But the invisible hand of competition constrains this selfish behavior and channels it into the service of the common good. The baker wants to produce bread with inferior and cheap inputs and charge $100 a loaf. Competition prevents him from doing so and we all enjoy the high quality products sold at low prices in our bakeries. Of course, Enron's executives presided over a business more complex than baking bread. But basically, their behavior is still subject to competition in the market. Many in history have tried to corner the markets for silver, wheat and energy. None have succeeded. Substitute supplies and other market responses always prevent the success of such activities.

However it is less well known that markets also work to prevent greed in the form of excessive compensation, bonuses, stock options, insider trading and cheating on the published accounts. There are financial specialists and competitors in the industry, who watch public corporations and note when such practices reduce the value of the offending companies' shares.

These depressed share values provide the opportunity for financial gain through a number of strategies. These involve the surreptitious purchase of a controlling interest of offending companies in the open market. More often, the hostile takeover involves also the offer to buy shares at a premium above the market rate. The takeover sometimes is financed by the issuance of junk bonds. Alternatively, a takeover company offers to swap its own shares for those of the target company at rates that the existing shareholders cannot refuse.

The rush to intervene often does more harm than good.

Throughout history, such hostile takeovers were profitable because the board of directors installed by new owners would eliminate practices that caused share prices to be depressed. Thus, executives with excessive compensation are replaced, bonus and option plans adjusted and shady accounting and self-dealing eliminated. The resultant increase in the value of the company's shares would be sufficient to repay bonds used to finance the takeover, leaving a tidy profit as the return to the activities that led to the discovery of the improperly managed company. The hostile takeover by rival firms in the same industry often also ended practices that depressed the value of the target companies. In addition, they gained from economies of scale and organizational synergies.

Of course, the business of hostile takeovers has always been risky. Information about the potential profit opportunities is uncertain. Awakened to the threat of a takeover, managers often mend their ways. Competitors prepare alternative takeover plans. As a result, sometimes the shares of the companies taking over decrease, often while the shares of the target companies rise in value. But studies have shown that most hostile takeovers have been profitable in the sense that they resulted in an increased share values for the two companies combined.

Executives, boards of directors, unions and many others in the companies taken over through hostile bids do not like what happens to them in the aftermath. They lose their jobs and prestige while the takeover specialists make huge profits. It is understandable that these people have a strong incentive to appeal to governments and regulators to make hostile takeovers more difficult. In the U.S., during the 1960s and 1980s these appeals resulted in new regulations.

The Williams Act of 1968 required the notification of the SEC of the intent of hostile takeovers and made it much more difficult to carry them out successfully. State regulators authorized the easy use of poison pills and other practices that allow the managers of firms targeted to delay or prevent the takeover. They also permit executives to exact large settlements for themselves before they lose their jobs. During the late 1980s, after a rash of hostile takeovers and during a business downturn, new state regulations made the practice even more difficult. The State of Delaware made its regulatory environment so attractive that many companies moved there from other parts of the U.S.

Anti-Competition

A number of analysts have concluded that the recent rash of corporate scandals in the U.S. can be attributed directly to the aforementioned legislation, which has reduced the opportunities for and increased the cost of hostile takeovers. Government regulation in effect has allowed greed to run free. It is as if the government had protected bakers from all competition and they used that freedom to enrich themselves.

In this tale lies a lesson for Canada. The government and regulatory authorities in Canada must not give in to demands for more regulation of the capital markets. Policies designed to protect shareholders inevitably end up serving the interest of existing companies, their executives, directors and unions. Instead, many existing regulations should be scrapped and more of the powerful policing forces of the market given free reign. Shareholders and the general public would benefit immensely.

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